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Assessing the Impact of Financial Leverage on the Profitability of Indian Companies

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ABSTRACT

Finance is defined as providing money when needed. All businesses, whether large or small, need funding to stay active and achieve their goals. No business can achieve its goals without adequate funding. Finance refers to the management of cash flow through an organization. It involves the application of technology to manipulate, use and control money. From the beginning to the end, finance has vital role in a company. It is necessary that correct estimate of the current and future need of capital be made to have an optimum capital structure which shall help the organization to run its work smoothly and without any stress. As a matter of fact, finance is very important aspect in any business. With huge funds, daily cash flow and continuous transactions, managing and monitoring all the above turn necessary To be specific financial management helps the organisation determine what to spend, where to spend and when to spend and finance is the functional process of business which helps to meet goals and objectives. This paper is about Impact of Financial Leverage on Profitability of renowned Indian companies.

KEYWORDS: Leverage, EBT,EBIT,DFL Profit planning ,capital

INTRODUCTION

Financial leverage measures how a business uses its equity and debt to finance its assets. A company can finance its investments through debt and equity. Companies may also use preferred capital. The interest rate on the debt is fixed regardless of the rate of return on the company's assets. Financial leverage used by companies is designed to earn more on fixed payment funds than cost premiums.

Here, an attempt is made to study the leverage analysis and profitability of selected automobile companies (Mahindra & Mahindra, Tata Motors and Bajaj Auto) in India during the periods from 2018 to 2022. Financing the company's assets is a major problem in all kinds of business. Use of long time fixed interest having debt & preference shared capital along with the equity shares is known as financial leverage or also called as trading on equity.

Leverage means use of funds or employment of assets in the capital structure of the firm for which the firm has to pay fixed cost or fixed return. The use of these funds will help increase the company's profitability. A company's leverage is primarily concerned with measuring profits, which can be either investment income or pre-tax profit. The right combination of operating and financial leverage helps a company grow, while the wrong combination of leverage limits a company's growth.

Degree of Financial Leverage (DFL): The DFL ratio can indicate the level of financial leverage a company has, which affects earnings volatility. Businesses use leverage ratios to analyse their financial strength and long-term success.

DFL = (EBIT) / (EBT)

DFL: degree of Financial Leverage, **EBIT:** earnings before interest and tax, **EBT:** earnings before tax.

Characteristics of Financial Leverage

- Financial leverage is the negative part of the balance sheet.
- Leverage determines the combination of different ways to finance the required assets.
- Financial leverage relates to financial risk.

Importance of Financial Leverage:

- **Capital Structure Planning:** Financial leverage relates to a reasonable balance between debt and equity. To this end, the optimal capital structure is determined
- **Profit Planning:** One of the tools used in profit planning is break-even analysis. We have seen break-even analysis used to understand the concept of financial leverage**.**
- **Increase shareholder returns:** Higher dividends may be declared when financial leverage is favourable. This will improve your company's reputation. This leads to an increase in the stock's market value.
- **Risk Measurement:** A high level of financial leverage indicates that the company is operating in a very risky environment and vice versa. Thus, financial leverage helps measure risk.

LITERATURE REVIEW

Covers all aspects of financial leverage and has been reviewed in detail as described below.

- **Subramaniam (2018)** investigated the effect of financial leverage on the profitability of Coromandel Packaging Limited. The period from 1985-86 to 2013-14 is considered. Regression results show that the DOL, DFL and DTL coefficients are positive in ROCE but not significant. However, the overall pattern is statistically significant. The coefficients of DOL, DFL, and DTL are positive in ROE, but not significant. It concludes that coromandel Packaging Limited has satisfactory levels of operational and combined leverage.
- **Reddy (2016)** studied the effect of leverage on the profitability of Tata Steel Limited. Data was collected over 5 years. Data were analysed using percentage, mean, ratio, correlation analysis and Student's t-test. The conclusion was that we should improve our capital structure by improving our leverage ratio and rethink our capital structure.
- **Sarang S. Waykole (2015)** studied the effect of leverage on capital returns. Data was collected from financial statements over a three-year period. Mathematical tools such as averages and percentages are used for analysis. As a result, operating leverage, financial leverage, and combined leverage were found to be unfavourable due to 3-year sales fluctuations. This also reflected an upward trend. He also suggested that companies should try to increase sales to mitigate the effect of increased leverage.
- **Mehta (2014)** studied the effect of financial leverage on shareholder returns. Thirty-five public companies were selected for this study. The study is conducted for 5 years. Financial leverage is used as the independent variable and shareholder return as the dependent variable. As a result, it was concluded that financial leverage does not affect shareholder return.
- **Patel (2014)** investigated the effect of leverage on the profitability of Sabar Dairy. This study investigated the relationship between return on capital used (ROCE), return on equity (ROE), return on assets (ROE) and earnings per share (EPS), along with operating, financial and total leverage. Regression results show that the DOL, DFL and DCL coefficients are

positive in ROCE but not significant. He concluded that Sabar Dairy had satisfactory use of operational leverage, financial leverage and combined leverage.

- **Soni Bindiya (2013)** used correlation analysis to examine the effect of operating and financial leverage on earnings per share. Along with this analysis, this report examines the effect of a debt-to-equity ratio on a company's earnings-per-share in order to determine the impact of debt on a company's wealth.

STUDY OBJECTIVES

- To perform a leverage analysis of selected automotive companies.
- Know the relationship between financial leverage and profitability for the selected car company.
- Investigate the impact of borrowing on the profitability of a selected car company.

AREAS OF STUDY/SCOPE

This study attempts to analyse the effect of leverage on the financial performance of selected automotive companies in India over the past several years. This will help management understand more opportunities.

WORKFLOW / METHODOLOGY

This study uses both analytical and descriptive research in support of secondary data. In this study, secondary data are collected from selected automotive companies' annual reports, publications in report format, magazine articles, and websites.

ANALYSIS TOOLS

- ➢ **Relationship Analysis**
- ➢ **Correlation Analysis**
- ➢ **Tables and Graphs**

Table: Degree of Financial leverage of leading Indian automobile companies

Data Interpretation

Data interpretation of Degree of Financial leverage of well-known Indian automobile companies. It is the ratio of EBIT to EBT.

Year	Mahindra & Mahindra	Tata Motors	Bajaj Auto
2018	1.56	1.83	0.89
2019	1.91	10.77	0.83
2020	1.41	2.29	0.85
2021	2.05	-0.75	0.78
2022	22	-5.71	0.8
Average	**5.78**	**1.69**	**0.83**

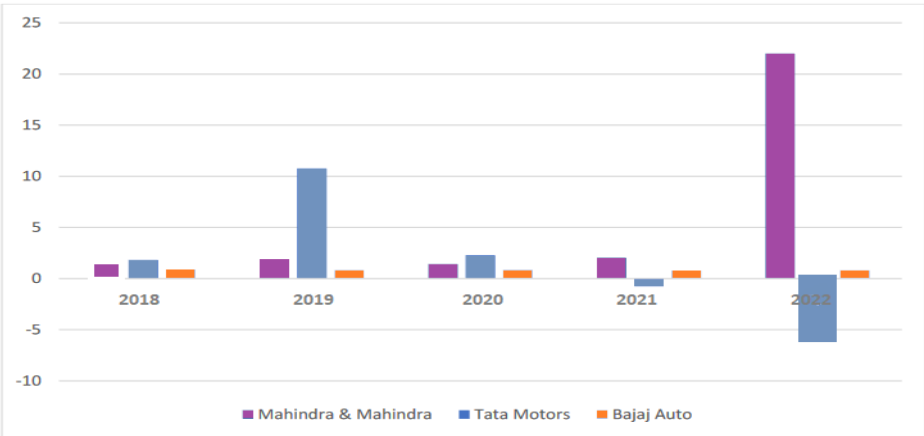
In the case of Mahindra & Mahindra it showed an uptrend. In the year 2020, financial leverage for 2020 is 1.41. In the coming years, it shows an upward trend. In 2021 it will be 2.05 and in 2022 the leverage will be 22. The average financial leverage is 5.78.

For Tata Motors, the average ratio is 1.69. It is showing a downward trend. Financial leverage for 2020 is 2.29. In the coming years, it shows a downward trend. In 2021 it will be -0.75 and in 2022 the leverage will be -5.71.

For Bajaj Auto, the average coefficient is 0.83. It shows a constant trend for all years.

FINAL RESULTS FROM STUDY/ CONCLUDED OUTCOMES

The chart below provides a comparative analysis of the degree of financial leverage of three well-known Indian companies over the past five years **(2018-2022).**



Source : secondary data

The company's five-year annual report from 2018 to 2022. **Mahindra & Mahindra.** Data were analysed using ratio analysis and trend analysis. The highest level of financial leverage was observed in 2022.

Five-year annual report of the company from 2018 to 2022. **Tata Motors** data was analysed using ratio analysis and trend analysis. The highest level of financial leverage was observed in 2019.

Annual report of the company for five years from 2018 to 2022. **Bajaj Auto** data was analysed using ratio analysis and trend analysis. The highest level of financial leverage was observed in 2018.

Average leverage is highest for Mahindra & Mahindra. It has the highest financial risk compared to the other two companies. Bajaj Auto shows minimum/least financial leverage.

Mahindra & Mahindra have the highest financial risk. Proper capital structure planning is essential to reducing risk. They are expected to increase capital and reduce long-term borrowing in the company's capital structure.

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